Fiscal Note

Fiscal Services Division

HF 2440 – Capital Gains Exclusion (LSB 5083HZ)
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Fiscal Note Version – New

Description

House File 2440 expands Iowa's special capital gains income tax exclusion for the sale of a business. Under current law (**Iowa Code section 422.7(21)**), Iowa excludes from State income tax any capital gains realized from the sale of all or substantially all of the tangible personal property of a business, or from the sale of a business in its entirety.

This Bill will expand the sale definition to include all or substantially all of the taxpayer's stock or equity interest in a business. The property of the business, or the entire business will not have to be sold to new owners. Under current law and under the proposed expansion, the seller is generally required to have materially participated in the business for at least 10 years and to have owned some interest in the business for at least 10 years in order to qualify for the income tax exclusion.

This Bill is retroactive to January 1, 2014.

Background

Iowa's current capital gains exclusion for the sale of a business has been in place as a 100.0% exclusion since tax year 1998 (HF 2513, Miscellaneous Tax Act of 1998). Prior to that time, the exclusion was limited.

Subject to requirements and limitations, Iowa also has capital gains exclusions for the sale of horses, cattle, and other breeding livestock, the sale of timber, and for Employee Stock Ownership Plans (ESOP).

The current law capital gains exclusion for the sale of a business and the proposed expansion to include the sale of the taxpayer's stock or equity interest in a business requires three conditions to be met:

- The taxpayer must have had an ownership interest in the sold asset for at least 10 years.
- The taxpayer must have "materially participated" in the business as defined in section 469(h) of the federal Internal Revenue Code. Internal Revenue Code **Section 469** relates to limitations on losses and credits for passive business activity and section 469(h) provides that a taxpayer materially participates in an activity only if the taxpayer is involved in the operations of the activity on a basis defined as:
  - regular,
  - continuous, and
  - substantial.
- In general, material participation is required for a minimum of 10 years. However, when the taxpayer sells the asset to lineal descendants, material participation is not required.

According to Department of Revenue income tax statistics, the current capital gains income tax exclusions provided in [Iowa Code section 422.7(21)] were utilized on 10,391 tax returns filed for tax year 2012 and the exclusion resulted in a tax reduction of $80.7 million for the benefiting taxpayers.

Assumptions

- Using State and federal tax returns of Iowa taxpayers, it is not possible to confirm what share of the long-term capital gains reported on Iowa tax returns represent the sale of all or substantially all of the taxpayer's stock or equity interest in a business in which the taxpayer materially participated for at least 10 years.
- For purposes of this projection, it is assumed that the new capital gains deduction will apply to 5.5% ($182.2 million in tax year 2012) of all positive long-term capital gains.
- The future growth in capital gains is assumed to equal the S & P 500 growth projections provided by Moody's Analytics (February 2014 projection).
- The assumed average marginal tax rate is 8.90%.
- The conversion of tax year model results to fiscal year General Fund revenue impacts was completed based on historical patterns of withholding, estimates, final returns, and refunds.
- Exclusions from State income tax reduce the statewide yield on the local option income tax for schools by 3.5% of the net General Fund impact.

Fiscal Impact

The capital gains income tax exclusion contained in this Bill is projected to reduce net General Fund revenue by the following amounts:

- FY 2014 = $ 0.7 million
- FY 2015 = $23.1 million
- FY 2016 = $21.4 million
- FY 2017 = $21.8 million
- FY 2018 = $22.2 million

The projected impact will continue beyond FY 2018 at a similar level. In addition to the State General Fund impact, the capital gains exclusion will also reduce annual local option income surtax for schools revenue by $745,000, beginning in FY 2015.

Sources

Department of Revenue
Moody's Analytics

/s/ Holly M. Lyons

March 18, 2014

The fiscal note for this bill was prepared pursuant to **Joint Rule 17** and the Iowa Code. Data used in developing this fiscal note is available from the Fiscal Services Division of the Legislative Services Agency upon request.